Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:[redacted]:[redacted]:TL-N-7091-98
[redacted]

date: JUN 24 1999

to: [redacted], Case Manager
Examination Division, Group [redacted]

from: Associate District Counsel, [redacted]

subject: [redacted], Inc.
Lease Stripping Transaction

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On March 17, 1999, Attorney [redacted] and the case agents participated in a telephone conference with numerous individuals from the Office of Chief Counsel concerning the lease stripping transaction entered into by [redacted], Inc. During the conference, the National Office suggested that additional arguments be considered by the case agent in reviewing the validity of the lease stripping transaction. Based upon information set forth in the proposed revenue agent's report, the National Office has suggested consideration of the following arguments, which are generally applicable to lease stripping transactions.

Step Transaction Issue

LAW AND ANALYSIS

The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent and focused towards a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

The step transaction doctrine, as described above, allows the Service to argue that certain economically meaningless steps of a transaction can be collapsed or ignored. Thus, the issue is whether the step transaction doctrine can be applied in this case to eliminate economically meaningless steps.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The National Office has indicated that before it can comment on whether the step transaction doctrine applies in this case, they would need to know exactly how the agent would recharacterize the lease stripping transaction. In other words, they would need to know the specific steps that, in substance, occurred.

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I.R.C. § 269 Issue

LAW AND ANALYSIS

Section 269(a) authorizes the Service to disallow any deduction or other allowance if: (1) any person or persons directly or indirectly acquire control of a corporation or (2) any corporation acquires property from an unrelated corporation in a transaction in which the basis of the property carries over, and, in either case, the principal purpose for the acquisition is to evade or avoid Federal income tax by securing the benefit of a deduction or other allowance that such person or corporation would not otherwise enjoy.

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I.R.C. § 351 Issue

LAW AND ANALYSIS

[redacted]

Generally, I.R.C. § 351 provides that investors do not recognize gain or loss if they transfer property to a corporation solely in exchange for its stock and if the transferors, as a group, are in control of the transferee corporation immediately after the exchange. For purposes of I.R.C. § 351, control is defined as ownership of 80 percent of the total combined voting power of all classes entitled to vote and 80 percent of the total number of shares of all other classes of stock of the transferee corporation (I.R.C. §§ 351(a) and 368(c)). The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met. Subject to certain limitations, to determine control, a group of transferors may include all of the transferee stock owned by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction.

If I.R.C. § 351 applies to an exchange, under I.R.C. § 362(a)(1) the transferee corporation takes the same basis in the assets it received from the transferor as the transferor had in such assets increased by the amount of gain, if any, recognized to the transferor. [redacted]

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(b)(5)(AC), (b)(7)a (b)(5)(AC), (b)(7)a [redacted]

(b)(5)(AC), (b)(7)a [redacted] Opinions discussing other I.R.C. § 351 issues often indicate that the taxpayer had a valid business purpose for the transaction in question. See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps the most thorough judicial exploration of the business purpose doctrine in I.R.C. § 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). In Caruth, the court explains that I.R.C. § 351 is tied very closely to the reorganization provisions and reasons that the doctrines applicable there are equally valid for capital contributions. Under Caruth, the business purpose requirement for I.R.C. § 351 transactions appears to be the same as the business purpose requirement for acquisitive reorganizations. Generally, I.R.C. § 351 will apply to a transaction if the taxpayer has a valid business purpose for the transaction other than tax savings. See Stewart v. Commissioner, 714 F.2d 977,991 (9th Cir. 1983); Rev. Rul. 60-331, 1960-2 C.B. 189, 191.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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(b)(5)(AC), (b)(7)a [redacted]

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(b)(5)(AC), (b)(7)a [redacted]

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I.R.C. § 482 Issue

LAW AND ANALYSIS

Generally, in order for I.R.C. § 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. I.R.C. § 482. To the extent that it can be shown that a transaction was carried out pursuant to a common design intended to effect an arbitrary shifting of income and deductions, the participants in the common design may be treated for purposes of the transaction as "controlled by the same interests" for the purposes of I.R.C. § 482. Accordingly, in the lease stripping context, I.R.C. § 482 may be applied to prevent the arbitrary separation of deductions (steered to the entity subject to the U.S.'s taxing jurisdiction) from the income associated with those deductions (steered to an entity exempt from the U.S.'s taxing jurisdiction).

A. Section 482 -- Generally

Section 482 provides the following:

> In any case of two or more organizations, trades, or businesses <u>owned or controlled directly or indirectly by the same interests,</u> the Secretary may distribute apportion, or allocate gross income, deductions... between or among such organizations...if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations. [Emphasis added].

Thus, in order for I.R.C. § 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. As there is no common ownership among the participants to the transaction (other than [redacted]s ownership of [redacted]), the primary question under I.R.C. § 482 becomes whether any of the participants, particularly the trust, are controlled by the same interests.

B. Legal Standard for Control

The I.R.C. § 482 regulations define control "to include any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(a)(3), 1968-1 C.B. 218; Treas. Reg. § 1.482-IT(g)(4), 1993-1 C.B. 90; Treas. Reg. § 1.482-1(i)(4), 1994-2 C.B. 93. See also Appeal of Isse Koch & Company, Inc., 1 B.T.A. 624,627 (1925), acq., 1925-1 C.B. 2 ("[C]ontrol not arising or flowing from legally enforceable means may be just as effective in evading taxation as if found on the most formal and readily enforceable legal instrument."). The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. Id. Accord, Ach v. Commissioner, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert denied, 385 U.S. 899 (1966); Grenada Indus., Inc. v. Commissioner, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied, 346 U.S. 819 (1953), acq. in part and nonacq. in part, 1952-2 C.B. 2, 5; Rev. Rul. 65-142, 1965-1 C.B. 223,224; Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g, T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967).

Moreover, the 1968 regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(a)(3) (1968). See Dallas Ceramic Co. v. Commissioner, 598 F.2d 1382, 1389 (5th Cir. 1979), rev'g, 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (holding that based on Treas. Reg. § 1.482-1(a)(3) (1968), the Service properly argued that proof of income shifting between two corporations establishes a presumption of common control). Accord, Hall v. Commissioner, 294 F.2d 82 (5th Cir. 1961), aff'g, 32 T.C. 390 (1959), acq., 1959-2 C.B. 4 (referring to Reg. 111 § 29.45-1). The 1993 and 1994 regulations also contain this presumption, and add that control may exist as a result of the actions of "two or more taxpayers acting in concert with a common goal or purpose." Treas. Reg. § 1.482-IT(g)(4) (1993); Treas. Reg. § 1.482-1(i)(4) (1994). Accord DHL Corp. v. Commissioner, T.C. Memo. 1998-461 ("[W]hen the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled [in determining whether the control requirement under the 1968 regulations is satisfied]."). Thus, under the regulations, joint, legal ownership, or overlapping ownership, is not required for unrelated corporations to come within the purview of I.R.C. § 482 if income or deduction shifting is present, or if there is common goal to shift income or deductions. But see Lake Erie & Pittsburgh Railway Co. v. Commissioner, 5 T.C. 558 (1945), acq., 1945 C.B. 5, acq. withdrawn and substituted for nonacq., Rev. Rul. 65-142, 1965-1 C.B. 223; B. Forman v. Commissioner, 54 T.C. 912 (1970), rev'd in relevant part, 453 F.2d 1144 (2d Cir. 1972), cert denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972), nonacq, 1975-2 C.B. 3 (nonacquiescence relates to the Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with 1968, 1993, and 1994 I.R.C. § 482 regulations).

Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove the applicability of I.R.C. § 482 by establishing a shifting of income and deductions. Dallas Ceramic Tile Co., at 1390. (b)(5)(AC), (b)(7)a [redacted] (b)(5)(AC), (b)(7)a [redacted] (b)(5)(AC), (b)(7)a [redacted]

C. Legal Standard for "Same Interests"

If control is found to exist, the Service may allocate income and deductions among members of the "controlled group." Treas. Reg. § 1.482-1(b)(1) (1968); Treas. Reg. § 1.482-1T(a)(2) (1993); Treas. Reg. § 1.482-1(a)(2) (1994). A controlled group or controlled taxpayer is defined to mean the entities owned or controlled by the "same interests," and includes the taxpayer that owns or controls other taxpayers. Treas. Reg. § 1.482-1(a)(5) (1968); Treas. Reg. §§ 1.482-1T(4), (5) (1993); Treas. Reg. §§ 1.482-1(i)(5), (6) (1994). Unlike the term "control," the phrase "same interests" is not defined in the I.R.C. § 482 regulations. Case law as well as the legislative history of I.R.C. § 482 provide guidance, however.

Section 482 was enacted to prevent the artificial shifting of income between controlled taxpayers to avoid Federal taxes, and thereby "milk" a taxable entity, i.e., placing deductions in one entity and income related to those deductions in another entity. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979), citing, H. Rep. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384,395; S. Rep. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409,426. See also H. Rep. No. 350 and S. Rep. No. 275, 67th Cong., 1st Sess. (1921). In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham, 598 F.2d at 1379; South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), aff'g, 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967); Appeal of Rishell Phonograph Co., 2 B.T.A. 229,233 (1925). See also LXI-Part 6 Cong. Rec. 5827 (1921) (statement of Sen. King referring to the "same forces" controlling a number of corporations). Different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute. South Texas Rice Warehouse, 366 F.2d at 894-95. See also Brittingham, 598 F.2d at 1378-79, citing Ach, 42 T.C. at 125-26 (The phrase, "same interests," should not be narrowly construed to frustrate the intent of I.R.C. § 482); Rishell Phonograph, 2 B.T.A. at 233 ("If 'the same interests' was intended to mean only 'the same persons,' it would have been easy for Congress, by using the latter term, to have avoided all ambiguity."). Accord Grenada Indus.

Thus, it is not necessary that the same person or persons own or control each controlled business before I.R.C. § 482 can be applied, but there must be a common design for the shifting of income in order for different entities to constitute the "same interests." Indeed, this definition of same interests is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Consequently, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met.

D. Control by the Same Interests in the Transaction

1. Common Plan Theory

Based on the facts as presented, we believe the parties to the transaction likely acted pursuant to a common plan to shift income and deductions in a manner that was beneficial to each participant in the transaction. [redacted]

Further, based on: (1) the close proximity in time between the various steps and (2) the peculiarly circular cash flows between the parties to the transaction, it is believed that each of the parties to the transaction acted pursuant to a common plan to effect the lease strip. [redacted]

2. Alternative Control Theory -- Ability to Direct the

Actions

The Examination team may wish to establish control among the participants under an alternative theory that does not rely on evidence of a common plan. Specifically, if it can be shown that certain participants had the ability to direct the actions of other participants, control may be found to exist. See, Hall, 32 T.C. at 409-10 (An arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of I.R.C. § 482, whether or not ownership exists). [redacted]

E. Section 482's Application to the Transaction -- In General

Generally, the Service has considered applying I.R.C. § 482 to lease stripping transactions under three alternative analyses. The application of these three analyses to a lease stripping transaction, however, does not preclude the application of other theories, such as the sham and step-transaction doctrines, to the transaction. The I.R.C. § 482 analyses should be applied in conjunction with these other theories, because I.R.C. § 482 applies whether or not a transaction is a sham or otherwise colorable where a transaction is merely a device to shift income or deductions. Treas. Reg. § 1.482-1(c) (1968); Treas. Reg. § 1.482-1T(d)(1)(i) (1993); Treas. Reg. § 1.482-1(f)(1)(i) (1994); G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 367 (1987).

1. Economic Substance

Section 482 overlaps with the case law relating to economic substance and sham doctrines by allowing the Service, in certain instances, to disregard contractual terms and agreements and to recharacterize a transaction. See Treas. Reg. §§ 1.482-2T(a)(1)(ii)(B), -2T(a)(3) (1993); Treas. Reg. §§ 1.482-1(d)(3)(ii)(B)(1), 1(d)(3)(ii)(C) ex. 3,-1(f)(2)(ii),-2(a)(1)(ii)(B),-2(a)(3),-4(f)(3)(ii)(A) (1994). See also, B. Forman, supra, 453 F.2d at 1160-1, and Medieval Attractions N.V.v. Commissioner, T.C. Memo. 1996-455 (RIA) 3277, 3322 (applying the 1968 I.R.C. § 482 regulations to analyze the economic substance of intercompany contracts). However, the I.R.C. § 482 regulations expand upon case law principles and provide additional guidance in specific areas. Specifically, the regulations provide the following:

The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, great weight will be given to the actual conduct of the parties, and the respective legal rights of the parties. If the contractual terms are inconsistent with economic substance of the underlying transaction, the Service may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1994); Treas. Reg. § 1.482-IT(d)(1)(1993). Thus, I.R.C. § 482 provides an alternative approach to challenging the transaction by providing additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and not restricting the Service's allocation authority to instances of "colorable" or "sham" transactions. See G.D. Searle, 88 T.C. at 367. We note that in the context of the transaction (and similar tax-shelter transactions), this allocation authority would exist only where there is a common tax avoidance scheme among the participants to arbitrarily shift income and/or deductions. [Note, the prior sentence does not apply to the alternative theory discussed above for establishing control (the ability to direct the actions of certain participants).]

Under the first I.R.C. § 482 analysis, the economic substance of a transaction subject to I.R.C. § 482 is analyzed by focusing on the parties' actual conduct; the economic risks purportedly transferred; and whether, from a business perspective, the transaction makes objective business sense, or under the language of some cases, would have been entered into by a "hard-headed business [person]." See Treas. Reg. § 1.482-1(d)(1) (1968); Treas. Reg. § 1.482-IT(d)(1) (1993); Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994). Where the economic substance of a transaction is inconsistent with the parties' purported characterization, the Service may disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance. This treatment may result in a denial of deductions arising from the transaction at issue. See, e.g., B. Forman, 453 F.2d at 1160-1; Medieval Attractions, at 3322 (royalty payments lacked economic substance under I.R.C. § 482, because the foreign payee was not the creator or developer of, nor in substance had the ability to, transfer intangibles.).

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2. Section 482's Role in Nonrecognition Transactions

The second I.R.C. § 482 analysis that may be applied to the transaction relates to its role in nonrecognition transactions, such as I.R.C. § 351 transactions. Specifically, I.R.C. § 482 may apply in nonrecognition transactions to prevent the avoidance of taxes or clearly reflect income. For example, I.R.C. § 482 may allocate income and deductions attributable to an entity's disposition of built-in-loss (and gain) property, which it acquired in a nonrecognition transaction, to the contributing shareholder (or partner). See Treas. Reg. § 1.482-1(d)(5) (1968); Treas. Reg. § 1.482-1T(d)(1)(iii)(1993); Treas. Reg. § 1.482-1(f)(1)(iii)(1994); National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), aff'g, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943); Ruddick Corp. v. United States, 643 F.2d 747 (Cl. Ct. 1981), on remand, 3 Cl. Ct. 61, 65 (1983), aff'd without opinion, 732 F.2d 168 (Fed. Cir. 1984); Northwestern Nat. Bank of Minneapolis v. United States, 556 F.2d 889, 892 (8th Cir. 1977), aff'g, 37 A.F.T.R.2d ¶76-1400 (D. Minn. 1976); Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987), aff'g, 82 T.C. 830 (1984); Foster v. Commissioner, 80 T.C. 34, 160, 172-77 (1983), aff'd in relevant part, 756 F.2d 1430, 1433-4 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986). See also, Eli Lily & Co. v. Commissioner, 84 T.C. 996, 1119 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988) (restricting I.R.C. § 482's application to nonrecognition transactions in cases of tax avoidance).

The above analysis, relating to the reallocation to the contributing shareholder of the deduction attributable to an entity's disposition of built-in-loss property, may also be

applied to reallocate to the contributing shareholder the entity's depreciation deductions on built-in loss property, to the extent those deductions are attributable to the portion of the property's basis in excess of the property's fair market value at the time of the contribution. (By analogy, see the language of I.R.C. § 382(h)(2)(B), concerning the treatment of depreciation deductions attributable to built-in losses). (b)(5)(AC), (b [redacted]
(b)(5)(AC), (b)(7)a [redacted]

Furthermore, in the lease stripping context, this analysis applies by likening the contribution (in a nonrecognition transaction) of the obligation to pay rent after the income has been stripped off to a contribution of built-in-loss property. This is because the stripping off of income, combined with the continuing obligation to pay rent, creates continuing tax deductions (losses). This is in spite of the fact that the transferee (in the nonrecognition transaction) will pay little, if any, out-of-pocket cash. This is attributable to the fact that the cash inflows, consisting largely of (tax-free) principal, will offset the deductible outflows for rent. Accordingly, if a tax avoidance motive is present, which is often the case in lease stripping transactions, it is appropriate to allocate the built-in loss to the tax-exempt, contributing shareholder and prevent the evasion of taxes by the "investor."

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3. Clear Reflection of Income & Prevention of the Evasion of Taxes

The third theory under which a lease stripping transaction may be analyzed under I.R.C. § 482 relates to the Service's ability to allocate income and deductions in order to clearly reflect income and/or prevent the evasion of taxes. I.R.C. § 482;

Treas. Reg. § 1.482-1(d)(1) (1968); Treas. Reg. § 1.482-IT(a)(1) (1993); Treas. Reg. § 1.482-1(a)(1)(1994). This analysis, and the case law affirming the Service's exercise of this allocation authority, is not based upon an economic-substance analysis. Rather, it focuses on the distortions in taxable income caused by the separation of income from deductions. See Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1951), rev'g, 16 T.C. 882, cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962).

As stated in Notice 95-53, 1995-2 C.B. 334, the separation of income from deductions in lease stripping transactions does not clearly reflect income, particularly where they are achieved through a transaction structured to evade taxes. Lease stripping transactions are often effected by (a) creating an artificial separation of the rental income from the associated deductions by accelerating the rental income in the hands of an entity not subject to the U.S.'s taxing jurisdiction, and (b) by placing the deductions associated with the rental income in an entity subject to U.S. tax. See Notice 95-53. In such an instance, the Service may prevent this artificial shifting of income and deductions by (1) allocating the rental deductions from the U.S. taxpayer to the tax-exempt entity, or (2) allocating the rental income from the tax-exempt entity to the U.S. taxpayer. See, e.g., Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), afl'g, T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967); J.R. Land Co. v. Commissioner, 361 F.2d 607, 609-10 (4th Cir. 1966), aff'g sub nom, Brentwood Homes, Inc. v. United States, 240 F. Supp. 378 (E.D.N.C. 1965); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir.), rev'g, 16 T.C. 882 (1951), cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Advance Machinery Exchange, Inc. v . Commissioner, 196 F.2d 1006 (2d Cir. 1952), cert. denied, 344 U.S. 835 (1952).

Accordingly, it may be appropriate to either (1) allocate [redacted]'s deductions to the trust during the period the trust owned stock of [redacted], or (2) allocate income to [redacted] in proportion to the period [redacted] owned the interest in the equipment and leases, if such is the case. Such an allocation would match the income and the deductions associated with the income, and thereby constitute a clearer reflection of income than that which is represented by the transaction. Concomitantly, the evasion of taxes would be prevented.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Associate District Counsel

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:[redacted]:[redacted]:TL-N-7091-98
[redacted]

date: APR 01 1999

to: [redacted], Case Manager
Examination Division, Group [redacted]

from: Associate District Counsel, [redacted]

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subject: [redacted], Inc.
Lease Stripping Transaction

By memorandum dated December 10, 1998, this office provided advice concerning the [redacted] lease stripping issue. On March 17, 1999, Attorney [redacted] and the case agents participated in a telephone conference with numerous individuals from the Office of Chief Counsel with respect to the issue. During the conference, the National Office offered additional theories that should be considered by the case agent in attacking the validity of the lease stripping transaction.

(b)(7)c [redacted] advised that an argument under section 162 may stand on its own merits. For instance, even if the entire transaction is not considered a sham, that is, if the debts created were genuine, the court may still reject the transaction. In Goldstein v. Commissioner, 364 F.2d 734, 742 (2d Cir. 1966), the deductions were disallowed on the grounds that the transaction lacked any expectation of profit and was entered into by petitioner without any purpose except to obtain an interest deduction. In this case, the rental expense deductions taken by [redacted] can be denied because [redacted] had no intent to earn an economic profit from the transaction, as required under section 162. Portland golf Club v. Commissioner, 497 U.S. 154, 169 (1990). For example, the fact that the rental payments from the end users had been accelerated and passed through to the non-taxable entity prior to [redacted]'s involvement indicated that [redacted] never intended to make an economic profit. Additionally, if the residual interests in the equipment were overvalued and unrealistic, this may be an indication that [redacted] never intended to profit from the leases or the equipment.

The National Office also provided comments concerning the applicability of Rev. Rul. 1999-14, 1999-13 I.R.B. 1, to the facts of this case. In that revenue ruling, the Service concluded that "lease-in, lease-out" (LILO) transactions have no economic substance because the transaction lacks the potential for any significant economic consequences other than the creation of tax benefits. The Service stated that the presence of an insignificant pretax profit is not enough to imbue the transaction with economic substance. As support, the Service pointed to: (1) the circular flow of cash of the prepayment, deposit interest, sublease payments and loan interest payments, which eliminates any real economic effect of the deal; (2) the U.S. taxpayer's and bank's minimal economic risk due to the arrangements with the bank, which tie up the funds; and (3) the U.S. taxpayer's minimal exposure to the head lease residual due to the expectation that the foreign entity will either exercise its option or be forced to renew the sublease as required by the parties' arrangement. As a result of the transaction lacking economic substance, the Service concluded that the U.S. Taxpayer may not deduct, under sections 162 and 163, rent and interest paid or incurred in connection with the transaction.

The form of the parties' lease stripping transaction does not appear to reflect the transactions' economic substance. Since the Service believes that the lease stripping transactions have characteristics similar to that of LILO transactions, it is recommended that consideration be given to an approach similar to that used by the Service in Rev. Rul. 99-14 to deny [redacted], Inc. rental and interest deductions incurred in connection with the lease stripping transactions at issue.

We are advised that the National Office shall provide comments on making arguments under sections 482, 269 and 351. Those comments will be shared with you upon receipt.

/S/

[redacted]

Associate District Counsel

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:[redacted]:[redacted]:TL-N-7091-98
[redacted]

date: DEC 10 1998

to: [redacted], Case Manager
Examination Division, Group [redacted]

from: Associate District Counsel, [redacted]

subject: [redacted], Inc.
Lease Stripping Transaction

This document may contain taxpayer information subject to section 6103. /this document may also contain confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. Therefore, this document shall not be disclosed to taxpayers or their representatives or disclosed or circulated beyond office personnel having the requisite "need to know."

This is in response to your request for advice regarding the [redacted] lease stripping issue.

ISSUE

Whether the sale of certain end user leases may be recharacterized by the Service as financing arrangements.

CONCLUSION

Based upon the facts as currently developed, it does not appear that the transactions may be characterized as financing arrangements.

FACTUAL BACKGROUND

All of the facts set forth herein have been provided by the examining agent.

[redacted], Inc. is a [redacted] taxpayer currently under audit in the [redacted] District for the taxable years [redacted] and [redacted]. [redacted] owns [redacted]% of the stock of [redacted], which in turn owns [redacted]% of the common stock of [redacted], [redacted] [redacted] and [redacted] are members of the consolidated income tax return filed by [redacted], Inc.

During the year taxable [redacted], [redacted] entered into four complex leasing transactions involving numerous related and unrelated entities. The apparent purpose of the transactions was to create a mismatch of income and deductions. Three of the leasing transactions involved sale and leasebacks of the property, an assignment of future rental income culminating in the acceleration of that income, and a purported tax-free exchange under section 351. The examination team continues to develop the facts involved in these transactions and intends to assert arguments based upon, among other things, the lack of economic substance, sham transactions and step transaction doctrine. Although the examination team shall continue developing this case with a view toward the various theories available to disallow the paper losses, the examiner has requested our views concerning whether the assignment of the lessor's rights may be considered a financing arrangement rather than a bona fide sale.

According to the revenue agent, the sale versus financial arrangement issue exists in three of the four transactions entered into by the taxpayer. These leasing transactions are known as the [redacted], [redacted] and [redacted] transactions. Each transaction is structured somewhat differently and involves different entities. However, the end result of the various transactions is to create large paper deductions for the taxpayer beginning in the taxable year [redacted]. The factual background of each transaction, as detailed by the examining agent, is summarized as follows.

1. [redacted] Transaction

In [redacted], [redacted], [redacted], Inc. ([redacted]) acquired computer equipment from various manufacturers and other leasing companies subject to existing net leases. The computer equipment was subject to thirteen separate net lease agreements with end users of the computers. The terms of the user leases expired at various times between [redacted] through [redacted]. [redacted] financed the equipment acquisition, in part, with nonrecourse loans from several financial institutions. As of [redacted], the amount of outstanding senior debt was $[redacted] and the amount of junior debt was $[redacted]. The future rental payments from the user leases totaled $[redacted] as of [redacted].

On [redacted], [redacted] sold the equipment, together with the user leases to [redacted] Trust I (Trust I), a [redacted] business trust. The beneficiary of Trust I was [redacted] Lease Associates, a partnership, whose partners were residents of the [redacted]. In addition to receiving the equipment and user leases, Trust I also acquired a secured nonrecourse promissory note of $[redacted] and residual certificate of $[redacted]. The purchase price for the equipment and other assets totaled $[redacted], which was paid as follows:

Assumption of Senior Financing	$[redacted]
Equity Note	
Nonrecourse Note	[redacted]
Total	$[redacted]

The equity note was a secured promissory note between [redacted] and Trust I, and was subordinate to the senior financing. It was a nonrecourse note payable from the proceeds of the user leases. The $[redacted] nonrecourse note was payable from the proceeds of the other assets.

On [redacted], Trust I entered into a five year master lease with [redacted] Trust II (Trust II), a [redacted] business trust. The beneficiary of Trust II was a partnership, [redacted], whose partners were residents of the [redacted]. Pursuant to the terms of the master lease, Trust I leased all the equipment to Trust II. Trust I also assigned all of its rights, title and interest in the user leases to Trust II. The lessor rights were encumbered by and subject to the senior, equity and nonrecourse notes mentioned above. The rental payments owed by the end users were to be remitted to the lessor (Trust I) in order to pay the senior financing.

The monthly rental payment due under the master lease was $[redacted] for a period of [redacted] months for total rent of $[redacted]. In addition to the monthly rental payments, Trust II was required to make a one time payment of $[redacted] to Trust I on January [redacted]. The master lease also provided that Trust II would owe Trust I a specified bonus rental in the event the equipment was remarketed.

On [redacted], Trust II also entered into a master remarketing agreement with [redacted], which authorized [redacted] to remarket the equipment after the expiration of the initial user leases. The agreement set forth the application of the proceeds from the remarketing.

On [redacted], Trust II sold its rights to receive the future rental payments from the user leases to [redacted] financial institutions. Trust II received a total of $[redacted] from the financial institutions as a result of the sale. At the time of sale, the future rental payments due under the various user leases totaled $[redacted]. Under the terms of the lease purchase agreements, the lease purchasers' sole remedy in the event of default in the payment of the user leases was to exercise the rights afforded to the original lessor with respect to default. According to the examiner, there are no known agreements guaranteeing payment to the lease purchasers in the event of default by the end users.

As a result of the sale of the future rental payments, Trust II purportedly realized rental income of $[redacted] in [redacted]. This income flowed to Trust II's beneficiary, [redacted], the partners of whom were residents of the [redacted] and not subject to United States income tax. Additionally, it is believed that the prepaid rental income received by the [redacted] partners is not taxable under the laws of the [redacted].

On [redacted], Trust I refinanced the senior debt by obtaining a loan from [redacted] ([redacted]) in the amount of $[redacted]. [redacted] was replaced as the senior lender for the equipment. Trust I granted a priority interest to [redacted] for its right, title and interest in the equipment, master lease agreements and existing user lease agreements. This refinanced debt was to be repaid in monthly installments of $[redacted], plus a payment of $[redacted] due on [redacted]. The monthly payment amounts were equal to the monthly payments owed by Trust II to Trust I on the master lease agreement. The master lease payments owed by Trust II to Trust I were required to be paid directly to [redacted].

The proceeds of $[redacted] received from the sale of the user lease were deposited into an escrowed certificate of deposit at [redacted]. Trust II posted the deposit as substitute collateral for its obligations under the master lease. This new collateral replaced the user leases. The certificate of deposit had a face value of $[redacted] on [redacted] and a maturity value of $[redacted] on [redacted]. This deposit was to be as collateral security by [redacted] for the replacement debt.

On [redacted], [redacted] executed an exchange agreement with Trust II and [redacted]. [redacted] exchanged [redacted] shares of preferred stock and [redacted] shares of common stock to [redacted] for $[redacted] and $[redacted], respectively. In addition, [redacted] exchanged [redacted] shares of preferred stock to Trust II for the assignment of Trust II's remaining rights and obligations with respect to the master lease, user leases, the deposit of $[redacted] and the remarketing agreement. The preferred shares were newly issued shares of Class A redeemable, nonvoting, nonconvertible preferred stock. The exchange of the preferred stock was tax free under I.R.C. § 351.

The deposit of $[redacted] was used by [redacted] to prepay the master lease rental payments totaling $[redacted]. The prepayment was discounted to $[redacted]. The funds used to prepay the master lease agreement were deposited into an account at [redacted] in the [redacted]. This deposit was held as collateral security for the [redacted] replacement debt. Although [redacted] does not report any rental income (since the prepaid rental income was purportedly received by Trust II), it claims deductions for the rental expense of $[redacted] over a [redacted] month period.

2. [redacted]

On July [redacted], [redacted] ([redacted]) acquired computer equipment from manufacturers and other leasing companies subject to thirteen existing user leases. These user leases had expiration dates which varied between November [redacted] and June [redacted]. At the time of the purchase the future rental payments due on the user leases totaled $[redacted]. [redacted] financed the equipment acquisition in part by nonrecourse loans from several financial institutions. These loans consisted of senior debt of $[redacted] and junior debt of $[redacted].

On July [redacted], [redacted] sold the computer equipment and the rights thereto to [redacted] Trust V (Trust V) for $[redacted]. Trust V is a Delaware business trust, the beneficiary of which is an individual who resides in [redacted]. The purchase by Trust V included all right, title and interest in the equipment and was subject to the user leases, senior liens and equity note. In addition to the equipment, Trust V acquired the right to purchase certain other equipment and the assignment of certain escrow agreements. The escrow held $[redacted] in funds for the senior debt. The purchase price of $[redacted] was paid in the following manner:

Assumption of Senior Financing	$[redacted]
Equity Note	
Cash	
Total	$[redacted]

The senior debt was assumed by Trust V and was recourse to, and secured only by, the equipment and user leases. The rental payments from the user leases were sufficient to pay the installment payments due on the senior debt. Trust V did not assume the junior debt. The equity note was a secured promissory note between [redacted] and Trust V, payable by [redacted]. It had a subordinate security interest against the equipment, user leases, purchase rights and escrow agreements.

On [redacted], immediately upon purchasing the equipment, Trust V sold the equipment, user leases and purchase rights to [redacted] Trust VI (Trust VI). Trust V retained the rights to the escrow agreements. Trust VI is a [redacted] business trust whose beneficiary is a resident of the [redacted]. The purchase price for the equipment, user leases and purchase rights totaled $[redacted], which was paid in the following manner:

Installment Promissory Note (Trust VI)	$[redacted]
Equity Note (Trust VI)	[redacted]
Cash	[redacted]
Total	$[redacted]

The senior debt was not assumed by Trust VI. Instead, new debt was issued and a purchase money security interest was granted in the equipment, lessor rights and purchase rights. The installment note was subordinate to the prior liens. The equity note between Trust VI and Trust V was due on [redacted], but was not paid until [redacted], as discussed below.

On [redacted], Trust V also entered into a prime (master) lease agreement with Trust VI. Pursuant to the terms of this prime lease, Trust VI, as lessor, leased all the equipment back to Trust V. Trust VI (lessor) assigned all of its right, title and interest in the user leases to Trust V. The rental payments from Trust V to Trust VI were equal to the amounts to be received by Trust V from the user leases. The term of the prime lease was also the same as the length of the user lease terms.

On [redacted], the date on which it acquired the equipment, Trust VI sold the equipment to [redacted] Trust VII (Trust VII), a [redacted] business trust. The beneficiary of Trust VII is [redacted] ([redacted]), a limited partnership. [redacted] has three equal partners, one of whom is a [redacted] resident and the other two are believed to be citizens of the United States. The purchase price for the equipment, user leases and purchase rights totaled $[redacted] and was paid as follows:

Installment Promissory Note (Trust VII)	$[redacted]
Equity Note (Trust VII)	[redacted]
Cash	[redacted]
Total	$[redacted]

The installment promissory note and the equity note were secured by a security interest in the equipment, lessor rights, purchase rights and master lease. The monthly principal and interest payments on the two notes totaled $[redacted].

On [redacted], Trust VI also entered into a [redacted] year master lease agreement (wrap lease) with Trust VII. (Sale and leaseback). Pursuant to the terms of this wrap lease, Trust VII, as lessor, leased all the equipment back to Trust VI. Trust VII also assigned all of the its right, title and interest in the user leases to

Trust VI, including the right to receive rental payments. The monthly rental payment owed by Trust VI to Trust VII for the master (wrap) lease totaled $[redacted], the same amount as the monthly loan payments owed by Trust VII to Trust VI on the installment and equity notes.

On [redacted], Trust V, Trust VI and Trust VII entered into separate remarketing agreements with [redacted].

On [redacted], Trust VI sold its right to receive the rental payments from Trust V under the prime lease to [redacted] ([redacted]) for $[redacted]. (The Trust V payments required by the prime lease were funded by the rental payments from the user leases.) This amount was equivalent to the outstanding balance of principal and interest due in connection with the ($[redacted] face value) installment note from Trust VI to Trust V. The proceeds from the sale of the prime lease rentals were used by Trust VI to satisfy the installment note.

[redacted], Trust VI, Trust V and the junior lenders agreed to release or subordinate their respective security interests in the equipment to the rights of [redacted]. [redacted] had no recourse against Trust VI for defaults by Trust V. [redacted]'s sole remedy in the event of nonpayment of the prime lease rentals was to exercise the rights afforded to the prime lease lessor upon default, including the right to re-lease the equipment.

As a result of this sale to [redacted], Trust VI purportedly realized taxable ordinary rental income of $[redacted] in [redacted]. This income flowed through to Trust VI's beneficiaries, who were nonresidents aliens and not subject to United States taxes.

On [redacted], [redacted] executed an exchange agreement with [redacted], Trust VI and others. [redacted] is the parent company of [redacted], owning [redacted]% of its common stock. [redacted] exchanged [redacted] shares of preferred stock to [redacted] for $[redacted]. In addition, [redacted] issued [redacted] shares of preferred stock to Trust VI and assumed Trust VI's equity note in exchange for Trust VI's remaining interest in the master lease, prime lease, Trust VII installment notes, remarketing agreement and lease purchase agreement. This transaction constituted a tax free exchange under I.R.C. § 351. On [redacted], [redacted] paid the equity note of $[redacted], plus interest to [redacted].

One of the rights acquired by [redacted] under the section 351 transfer was a loan due from Trust VII to Trust VI. The amount of the loan, $[redacted], was equal to the rents due from [redacted] to Trust VII under the master lease. [redacted] intends to deduct this rental expense over a [redacted] month period.

3. [redacted]

On [redacted], [redacted] acquired computer equipment from the manufacturers subject to four existing user leases. The expiration of the four user leases varied between [redacted] and [redacted]. At the time of the purchase the future rental payments due from the four leases totaled $[redacted]. [redacted] financed the equipment purchase in part by nonrecourse loans from [redacted] and [redacted]. The amount of senior debt was $[redacted] and the junior debt was $[redacted]. The examining agent has not identified the total amount paid for the equipment by [redacted].

On [redacted], [redacted] sold the equipment to [redacted] ([redacted]), a partnership. The purchase was subject to the user leases and the senior and junior liens. The purchase price for the equipment and the lessor rights totaled $[redacted] and was paid in the following manner:

Assumption of senior loan	$[redacted]
Short term promissory note	[redacted]
Short term promissory note	[redacted]
Total	$[redacted]

[redacted] assumed the senior debt, but [redacted] remained liable for the junior debt. The senior debt was recourse only to, and secured only by, the equipment and lessor rights. Rental proceeds from the user leases were to be used to pay the installments due on the senior debt. The two short term notes represented an obligation owed to [redacted] from [redacted] and were payable by September [redacted]. These notes were secured by a subordinated security interest in the equipment and lessor rights.

On [redacted], the date of its purchase of the equipment, [redacted] re-sold the equipment and lessor rights to [redacted] ([redacted]). [redacted] is a partnership whose [redacted]% partner is [redacted], a [redacted] partnership. The purchase price for the equipment and lessor rights was $[redacted], which was paid in the following manner:

Nonrecourse installment promissory note	$[redacted]
Promissory note	[redacted]
Total	$[redacted]

The senior debt was not assumed by [redacted]. Instead, new debt was issued whereby [redacted] became indebted to [redacted] for the amounts of the two notes. The installment note of $[redacted] was payable by [redacted] in fixed semiannual payments of $[redacted] with the first loan payment being $[redacted] and the last payment being $[redacted]. The total principal and interest due totaled $[redacted]. A security interest was granted in the equipment and lessor rights. The promissory note of $[redacted] was due on [redacted]. No interest was payable if the note was paid on the due date.

On [redacted], the date of the sale, [redacted] entered into a [redacted] month master lease with [redacted], whereby [redacted] leased all of the equipment and user lease rights back to [redacted]. The rental payments owed by [redacted] under the master lease consisted of semiannual payments of $[redacted] with the first payment being $[redacted] and the final payment being $[redacted]. The payments owed by [redacted] to [redacted] under the master lease were equal to the payments owed by [redacted] to [redacted] on the installment note. Therefore, no cash was exchanged between the parties for the rent or installment note.

On [redacted], [redacted] changed its business structure to a limited partnership. The new partnership was named [redacted] ([redacted]). [redacted] succeeded to all rights and obligations of [redacted] with respect to the [redacted] transaction. Also, on [redacted], [redacted] assigned the [redacted] recourse note of $[redacted] to [redacted] as payment for [redacted]'s $[redacted] note to [redacted].

On [redacted], [redacted] entered into a section 351 transaction with [redacted]. At this time, the examining agents have no further information concerning this transaction.

On [redacted], [redacted] assigned its entire interest in the master lease to [redacted] Trust VI (Trust VI). The examining agents have no further information concerning this transaction. We understand that the agents are attempting to obtain copies of the documents and agreements relating to this transaction.

On [redacted], Trust VI sold its lessor rights to the existing user leases to two financial institutions, [redacted] and [redacted], for $[redacted]. The purchasers acquired the rights to the future rental payments from the user leases. The cash payment received from the sale was used to discharge the senior debt. The lease purchasers had no recourse against the sellers in the event of default by the end users. The purchasers' sole remedy in the event of default was to exercise the lessor's rights with respect to default, including the right to re-lease the equipment.

On [redacted], [redacted] executed an exchange agreement with Trust VI, [redacted] Trust I and [redacted], its parent corporation. This exchange agreement involved both the [redacted] transaction and the [redacted] transaction (discussed above), along with another transaction not discussed herein ([redacted]). Trust VI was the assignor for the [redacted] and [redacted] transactions. As mentioned in the [redacted] discussion, [redacted] exchanged [redacted] shares of preferred stock to [redacted] for $[redacted]. In addition, [redacted] issued [redacted] shares of preferred stock to Trust VI and assumed a portion of the [redacted] equity note in exchange for Trust VI's remaining interests in the [redacted] and [redacted] transactions, including the [redacted] master lease, [redacted] user leases, the [redacted] installment note, lease purchase agreement and remarketing agreement. This transaction constituted a tax free exchange under I.R.C. § 351. On [redacted], [redacted] paid a portion of the recourse promissory note.

One of the rights acquire in the section 351 transaction was a loan from [redacted]/[redacted] to [redacted]. This loan was transferred to Trust VI and then to [redacted]. The amount of the loan, $[redacted] was equal to the rents due from [redacted] to [redacted] under the master lease. [redacted] intends to deduct the rental expense owed to [redacted] over a [redacted] month period.

The examining agent has requested our advise concerning whether the purported sales of the future rental income to the third parties may be recharacterized as a financing arrangement rather than a bona fide assignment. If a recharacterization is appropriate, the rental income would not be accelerated since the funds received from the assignment would be considered loan proceeds and not income. As a result, the rental income would be reportable by the taxpayer as the rental income accrues. This would eliminate the large paper losses claimed by the taxpayer.

DISCUSSION

Whether a transaction is treated as a sale or a secured financing for federal income tax purposes depends on the substance of the transaction, not its form. Higgins v. Smith, 308 U.S. 473, 477-78 (1940); Estate of Stranahan v. Commissioner, 472 F.2d 867, 869 (6th Cir. 1973), rev'g T.C. Memo. 1971-250. The substance of a transaction is determined by analyzing the facts surrounding the transfer and the type of asset involved. Estate of Stranahan v. Commissioner, 472 F.2d at 870-71. The labels, semantic technicalities, and formal written documents do not necessarily control the tax consequences of a given transaction. Houchins v. Commissioner, 79 T.C. 570, 589 (1982).

In discussing the paramount importance of considering the economic realities of a transaction, the Supreme Court in Frank Lyons Co. v. United States, 435 U.S. 561, 572-573 (1978) stated as follows:

> In a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of

> taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. (citations omitted). In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," ... as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding." Helvering v. Lazarus & Co., 308 U.S. at 255, 60 S.Ct. at 210.

The term "sale" is given its ordinary meaning for Federal income tax purposes and is generally defined as a transfer of property for money or a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-571 (1965). In deciding whether a particular transaction constitutes a sale, the question of whether the benefits and burdens of ownership have passed from seller to buyer must be answered. Falsetti v. Commissioner, 85 T.C. 332 (1980). For purposes of Federal income taxation, a sale occurs upon the transfer of the benefits and burdens of ownership rather than upon the satisfaction of the technical requirements for the passage of title under state law. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). The question of whether the benefits and burdens of ownership have been transferred is essentially one of fact to be ascertained from the intention of the parties as evidenced by the written agreements read in light of the attendant facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956).

Various factors which have been considered by the courts in making a determination as to whether a sale occurs were summarized in Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. at 1237-1238. Among the factors to be considered in making this determination are: (1) whether legal title passes; (2) the manner in which the parties treat the transaction; (3) whether the purchaser acquired any equity in the property; (4) whether the purchaser has any control over the property and, if so, the extent of such control; (5) whether the purchaser bears the risk of loss or damage to the property; and (6) whether the purchaser will receive any benefit from the operation or disposition of the property. When the transfer involves the right to receive future rental payments, factors 2, 5 and 6 become relevant to the inquiry.

The most important factor is whether the assignee bears the risk that the lessee will not make the future lease payments. See, Estate of Stranahan, 472 F.2d at 870-871 (holding that an assignment of future dividends was a sale even though assignee's only indicia of ownership was the slight risk that he would not receive the dividend income). When the assignment involves the right to receive future income in exchange for consideration, the courts have usually treated the transaction as a sale when the assignee bears the risk that the anticipated income will not be paid. Similarly, when the assignee is certain that it will be fully repaid, that certainty is characteristic of a loan. Mapco, Inc. v. United States, 556 F.2d 1107, 1110 (Ct. Cl. 1977). The courts have found certainty of repayment to the assignee if the assignee receives a security interest in the property generating the future income or the assignor guarantees that the amounts due will be paid. Watts Copy Systems v. Commissioner, T.C. Memo. 1994-124.

The Tax Court has sustained the Service's recharacterization of rights to future income as secured financing. In Martin v. Commissioner, 56 T.C. 1255 (1971), aff's, 469 F.2d 1406 (5th Cir. 1972), the taxpayer was a member of a partnership which owned an apartment building from which it received rental income during 1965 through 1967. The taxpayer was also a member of another partnership which sustained a substantial loss during 1966. In order to accelerate the rental partnership's income to absorb the loss from the other partnership, the taxpayer cause the rental partnership to assign its 1967 rents to a third party in return for a lump sum payment of $225,000. This payment, with a secondary sum of 7% of the unpaid balance of the primary sum, was to be paid to the buyer in the following year or years solely from the assigned rents.

The taxpayers in Martin contended that the $225,000 constituted proceeds from the 1966 sale of the rental income. Conversely, the Service argued that the transaction was in substance a loan, with which the Court ultimately agreed. In reaching that conclusion, the Court applied the assignment of income doctrine. According to the Court, "[i]ncome from property is taxable to the owner of such property, and a mere assignment of the right to receive such income is not enough to relieve the assignor of the tax." Martin, 56 T.C. at 1259, citing Helvering v. Horst, 311 U.S. 112 (1940), Additionally, the Court further held that the transaction was "purely and simply a device to avoid the proper taxation of the [taxpayers]." Id. at 1260.

To establish that an assignment is a secured financing, it is necessary to show that (1) the assignee received a security interest in the leased equipment, (2) the assignor expressly guaranteed the payment of the future income, or (3) the assignor implicitly guaranteed the payment of the future income. An implicit guarantee may arise because the assignor agreed to repurchase any lease in default. An implicit guarantee may also exist if the assignor provided the assignee with indirect collateral. For example, in Mapco, the court found an indirect guarantee of repayment where the assignor purchase certificates of deposit with maturity dates coinciding with the expected dates for repayment of the amount borrowed from the assignee bank.

In this case, the facts do not appear to support recharacterizing the lease assignments as financing arrangements. There exists no indication that the assignee received a security interest in the leased equipment or that the assignors either expressly or implicitly guaranteed payment of the future user rental payments. The various lease purchase agreements involved herein specifically provide that the lease sales are made without recourse to the respective sellers. This indicates that the lease purchasers assumed the risk in the event of default by the end users. We are unable to identify any agreement whereby the sellers guaranteed payment of the rental income to the lease purchasers or provided the purchasers with a security interest in the equipment. Without evidence that the lease purchasers did not bear the risk of loss resulting from the sale of the leases, we are unable to recommend that the transaction be recharacterized.

In order to pursue this issue further, additional factual development is necessary. The examining agent should obtain copies of all Uniform Commercial Code filings to ascertain whether any security interests were received by the lease purchasers in the equipment. The examiner should also attempt to establish whether any assurances were given to the lease purchasers regarding collection of the future rents and whether the lease purchasers would somehow be indemnified in the event of loss. If additional facts are developed to indicate that the lease purchasers did not bear the risk of loss from the end users, that information should be submitted to this office for further reconsideration of this issue.

If you have any questions in this matter, please contact [redacted] of this office at [redacted].

[redacted]

[redacted]
Associate District Counsel